

Interim Financial Statements of

**INTERNATIONAL WATER-GUARD  
INDUSTRIES INC.**

Three months ended December 31, 2004 and 2003

**Interim Financial Statements of**

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**

**Notice of no auditor review of interim financial statements to December 31, 2004**

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim financial statements of the Company have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**  
**BALANCE SHEETS**

|   | December 31<br><u>2004</u> | September 30<br><u>2004</u> |
|---|----------------------------|-----------------------------|
| <b>ASSETS</b>                               |                            |                             |
| Current assets:                             |                            |                             |
| Cash  | \$ 98,860                  | \$ 64,836                   |
| Accounts receivable                         | 392,242                    | 592,467                     |
| Inventory                                   | 355,231                    | 423,626                     |
| Prepaid expenses                            | <u>5,528</u>               | <u>5,529</u>                |
|   | 851,861                    | 1,086,458                   |
| <br>  |                            |                             |
| Furniture and equipment                     | <u>68,980</u>              | <u>75,586</u>               |
|   | <u>\$ 920,841</u>          | <u>\$ 1,162,044</u>         |
| <br>  |                            |                             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b> |                            |                             |
| Current liabilities:                        |                            |                             |
| Accounts payable and accrued liabilities    | \$ 910,158                 | \$ 1,018,965                |
| Factoring loan                              | 289,000                    | 449,500                     |
| Shareholder loan                            | 262,808                    | 256,507                     |
| Current portion of notes and loan payable   | <u>722,784</u>             | <u>731,571</u>              |
|   | <u>2,184,750</u>           | <u>2,456,543</u>            |
| <br>  |                            |                             |
| Loan payable                                | <u>29,021</u>              | <u>29,021</u>               |
| <br>  |                            |                             |
| Shareholders' equity (deficiency):          |                            |                             |
| Share capital                               | 6,530,913                  | 6,530,913                   |
| Deficit                                     | <u>(7,823,843)</u>         | <u>(7,854,433)</u>          |
|   | <u>(1,292,930)</u>         | <u>(1,323,520)</u>          |
|   | <u>\$ 920,841</u>          | <u>\$ 1,162,044</u>         |

These financial statements have been prepared by management and are unaudited.  
See accompanying notes to financial statements.

On behalf of the Board:

"J. D. Lawson"                      Director

"D. C. Fox"                          Director

# INTERNATIONAL WATER-GUARD INDUSTRIES INC.

## STATEMENTS OF OPERATIONS AND DEFICIT

Three months ended December 31, 2004 and 2003

|   | <u>2004</u>         | <u>2003</u>         |
|---|---------------------|---------------------|
| Sales                                       | \$ 770,948          | \$ 1,163,447        |
| Cost of goods sold                          | <u>269,671</u>      | <u>492,450</u>      |
| Gross profit                                | <u>501,277</u>      | <u>670,997</u>      |
| Expenses                                    |                     |                     |
| Selling expenses                            | 73,328              | 94,417              |
| Research & development                      | 91,952              | 88,567              |
| General, administrative & occupancy         | 246,008             | 267,929             |
| Amortization                                | 7,025               | 97,114              |
| Interest & bank charges                     | <u>52,374</u>       | <u>32,124</u>       |
|   | <u>470,687</u>      | <u>580,151</u>      |
| Net earnings for the period                 | 30,590              | 90,846              |
| Deficit, beginning of period                | <u>7,854,433</u>    | <u>3,919,598</u>    |
| Deficit, end of period                      | <u>\$ 7,823,843</u> | <u>\$ 3,828,752</u> |
| Earnings per share, basic and fully diluted | <u>\$ -</u>         | <u>\$ 0.01</u>      |
| Weighted average shares outstanding         | <u>20,481,194</u>   | <u>16,334,305</u>   |

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See accompanying notes to financial statements.

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**  
**STATEMENTS OF CASH FLOWS**  
**Three months ended December 31, 2004 and 2003**

|  | <u>2004</u>      | <u>2003</u>      |
|--|------------------|------------------|
| Cash flows from (used by):                     |                  |                  |
| Operations:                                    |                  |                  |
| Net earnings (loss) for the period             | \$ 30,590        | \$ 90,846        |
| Items not involving cash -                     |                  |                  |
| Amortization                                   | 7,025            | 97,114           |
| Interest accrued                               | 19,514           | 12,771           |
| Unrealized exchange gains                      | <u>(22,000)</u>  | <u>(17,093)</u>  |
|  | 35,129           | 183,638          |
| Changes in non-cash operating working capital: |                  |                  |
| Accounts receivable                            | 200,225          | (131,183)        |
| Inventory                                      | 68,395           | 51,666           |
| Prepaid expenses                               | 1                | 1                |
| Accounts payable and accrued liabilities       | (108,807)        | 13,735           |
| Customer deposits                              | <u>-</u>         | <u>(145,207)</u> |
|  | <u>194,943</u>   | <u>(27,350)</u>  |
| Investing activities:                          |                  |                  |
| Purchase of capital assets                     | (419)            | (158)            |
| Deferred aircraft system design                | <u>-</u>         | <u>(173,562)</u> |
|  | (419)            | (173,720)        |
| Financing activities:                          |                  |                  |
| Proceeds (repayment) of factoring loan         | (160,500)        | 61,350           |
| Repayment of note payable                      | -                | (72,750)         |
| Proceeds from exercise of warrants             | <u>-</u>         | <u>300,000</u>   |
|  | <u>(160,500)</u> | <u>288,600</u>   |
| Increase in cash                               | 34,024           | 87,530           |
| Cash (bank indebtedness) beginning of period   | <u>64,836</u>    | <u>(48,188)</u>  |
| Cash, end of period                            | <u>\$ 98,860</u> | <u>\$ 39,342</u> |
| Supplementary information                      |                  |                  |
| Interest paid                                  | \$ 32,859        | \$ 25,124        |
| Income taxes paid                              | \$ -             | \$ -             |

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See accompanying notes to financial statements.

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**  
**STATEMENTS OF COST OF GOODS SOLD**  
**Three months ended December 31, 2004 and 2003**

|                                  | <u>2004</u>       | <u>2003</u>       |
|----------------------------------|-------------------|-------------------|
| Opening inventory                | \$ 423,626        | \$ 630,814        |
| Manufacturing costs:             |                   |                   |
| Materials                        | 114,040           | 331,447           |
| Labour, freight and other        | <u>87,236</u>     | <u>109,337</u>    |
| Cost of goods available for sale | 624,902           | 1,071,598         |
| Closing inventory                | <u>355,231</u>    | <u>579,148</u>    |
| Cost of goods sold               | <u>\$ 269,671</u> | <u>\$ 492,450</u> |

These financial statements have been prepared by management and are unaudited.  
See accompanying notes to financial statements.

# INTERNATIONAL WATER-GUARD INDUSTRIES INC.

## Notes to Interim Financial Statements, December 31, 2004

1. These interim statements are prepared in a manner consistent with all accounting policies and methods applicable to the Company's audited annual financial statements. However, these interim financial statements do not include all disclosure in notes normally provided in annual financial statements, consequently this report should be read in conjunction with the Company's audited financial statements for the year ended September 30, 2004.

In management's opinion, the unaudited financial information includes all normal adjustments necessarily to present fairly such information. Interim results are not necessarily indicative of the results expected for the fiscal year.

2. The Company has a shareholder's deficit of \$1,289,386 as at December 31, 2004 as a result of losses incurred in past years. In addition, the Company has negative working capital of \$1,329,345, compared to negative working capital of \$1,370,085 at its fiscal year ended September 30, 2004.

These financial statements are prepared on a going concern basis that assumes the Company will realize its assets and discharge its liabilities in the normal course of business. The ability of the Company to continue as a going concern is dependent on its ability to generate positive cash flow from operations on a continuing basis.

The Company is renegotiating the payment terms on the notes payable to its largest creditors and continues to negotiate with its other suppliers and lenders in order to establish extended payment terms on remaining liabilities. In addition, on an ongoing basis, the Company identifies and evaluates external financing opportunities including government grants and equity financing. There can be no guarantee that sufficient sales volumes will be achieved to reschedule its outstanding liabilities or that external financing will be available when needed.

3. Authorized capital of the Company as at December 31, 2004 included 100,000,000 common shares and 5,000,000 preferred shares of which 20,481,194 common shares and no preferred shares were issued and outstanding. Included in issued common shares are 551,983 common shares subject to an escrow agreement, approved by the TSX Venture Exchange, which will be released from escrow on February 26, 2005.
4. Under the Company's stock option plan, there were 1,760,000 options outstanding as of December 31, 2004 of which 832,000 are exercisable and 928,000 have not yet vested. These options, held by directors, officers, and employees, are exercisable at \$0.64 as to 40,000 options until January 7, 2005; at \$0.20 as to 100,000 options until April 8, 2006; at \$0.18 as to 580,000 options until May 3, 2007; and at \$0.10 as to 1,040,000 options until July 30, 2007.
5. Warrants to purchase 940,000 common shares at \$0.25 per share were outstanding as at December 31, 2004. These options originally issued in conjunction with the private placement of common share units in March 2004 expire on September 16, 2005.
6. Contractual obligations of the Company are unchanged from those described within the notes to the audited financial statements.
7. Subsequently, on February 10<sup>th</sup>, 2005, the Company completed the closing of the sale for cash of its commercial and industrial business and assets to Violetta Industries Ltd. During fiscal 2004, sales of the division were \$488,000 representing 14% of the Company's fiscal 2004 sales. During 2004, the Company had indicated that it was seeking a suitable buyer for its commercial and industrial business so as to concentrate solely on the Company's aviation business. The results of this transaction will be included in the Company's second quarter report ended March 31, 2005.

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**

**MANAGEMENT'S DISCUSSION  
AND ANALYSIS**

**First Quarter Ended**

**December 31, 2004**

dated: February 15, 2005

# **INTERNATIONAL WATER-GUARD INDUSTRIES INC.**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

**First Quarter to December 31, 2004**

### **Overview**

Comments in this analysis should be read in conjunction with the comparative interim financial statements for the three months ended December 31, 2004. The following discussion, and the information elsewhere in this report, is intended to provide the reader with a further understanding of the Company's business and factors underlying its financial results.

International Water-Guard Industries Inc. ("IWG") designs, manufactures, sells, installs and services potable and process water treatment/management equipment and systems, primarily for international aviation customers. The principal technology embodied in IWG's products is irradiation by ultraviolet ("UV") light, with filtration, ancillary systems and controls designed by the Company.

The Company has been substantially a development company, with base operations and revenues covering a portion of its product, aviation water systems and market development costs. New equity issues have provided the remainder of the Company's capital commitments and working capital requirements. Sales trends are subject to industry cycles and customer adoption of the Company's technology.

### **Operating results**

The Company reported sales during the first quarter in fiscal 2005 of \$770,948, a decrease of 34% from the previous year. Included in prior year sales was the delivery of three aircraft circulating potable water systems (C-PWS™). Net earnings were \$30,590 during the quarter compared to earnings of \$90,846 in the prior year's first quarter. The results for the quarter provided nil earnings per share in the current quarter compared to earnings of \$0.01 per share in the prior year on both a basic and fully diluted basis.

### **Sales**

Sales of aviation products during the first quarter ended December 31, 2004 of \$662,040 (representing 86% of total sales) decreased by 35% from prior year's first quarter aviation sales of \$1,163,447. As noted above, included in prior year sales was the delivery of three aircraft circulating potable water systems while none were delivered in the current quarter. Partially offsetting this decrease was the increased aviation water treatment equipment and parts sales over the prior year's first quarter.

Industrial sales of \$108,908 to the aquaculture and other water process applications, representing 14% of current quarter sales, decreased by 22% from the prior year. This decrease resulted from reduced emphasis and resulting support to this sector while the company focuses primarily on its aviation products and systems. The company's previously announced intention to seek a buyer for this division's business and assets has been concluded with the closing of a sale agreement on February 10, 2005.

### **Direct sales margins**

The dollar value of overall direct sales margins decreased from the same quarter of a year earlier principally due to lower sales. However, due to the change in sales mix to more equipment and parts sales, margin rates increased to 65% compared to 58% in the prior year.

## Operating expenses

Selling expenses of \$73,328 for this quarter were 22% less than in for the comparable period in the prior year. The decrease was due principally to a short-term reduction in travel and sales personnel during the quarter.

Engineering and product development expenses (excluding C-PWS™ development) charged to earnings of \$91,952 was similar to that of same period in the prior year. There were no C-PWS™ development costs incurred in the current quarter.

General, administration, information technology and occupancy expenses totaled \$246,008, a 8% decrease from the same quarter in the prior year. This decrease was primarily attributed to decreased consulting fees incurred in this quarter.

## Aircraft water system development costs

As noted, there were no aircraft water system development costs incurred in this quarter.

In future periods, the deferment of development costs under the Company's adopted policy of deferring such costs will be determined on a case by case basis.

## Capital expenditures

Capital expenditures incurred by the company for plant or equipment were not significant in the current quarter results.

## Quarterly information

The following summary information is taken from the Company's quarterly and annual financial reports covering the last two fiscal years.

### Quarterly Results Reported for: (\$000's except per share amounts)

|   | Fiscal 2005 | Fiscal year 2004 |          |          |         | Fiscal year 2003 |          |          |
|---|-------------|------------------|----------|----------|---------|------------------|----------|----------|
|   | Dec 31      | Sep 30           | Jun 30   | Mar 31   | Dec 31  | Sep 30           | Jun 30   | Mar 31   |
| Sales   | \$771       | \$753            | \$934    | \$791    | \$1,163 | \$860            | \$734    | \$706    |
| Earnings (loss) from operations, before write-downs | 31          | (34)             | (162)    | 4        | 91      | (226)            | (123)    | (92)     |
| Write down of deferred and other assets             | 0           | (3,834)          | 0        | 0        | 0       | (162)            | 0        | 0        |
| Net income (loss)                                   | 31          | (3,868)          | (162)    | 4        | 91      | (388)            | (123)    | (92)     |
| Earnings (loss) per share, basic and fully diluted  | \$0.00      | \$(0.21)         | \$(0.01) | \$(0.00) | \$0.01  | \$(0.03)         | \$(0.01) | \$(0.00) |

Fluctuations in sales from quarter to quarter were mainly related to the delivery of the Company's C-PWS™, although there are no factors which may be used to predict future performance in either sales or in net income or loss on a quarter to quarter basis.

## **Liquidity and capital resources**

### **Cash flow from operations:**

Cash provided from operating activities, before non-cash operating working capital, was \$35,129 in the current quarter compared to \$183,638 in the comparable period of the prior year. A reduction in operating assets, less a reduction of liabilities, provided a further \$159,814 during the quarter.

### **Cash flow from financing activities:**

A repayment of advances of \$160,500 was made under the Company's credit line, to a factoring company.

### **Working capital position:**

The Company completed its first quarter ended December 31, 2004 with \$1,329,345 in negative working capital, an improvement of \$40,740 from its fiscal year end. This decrease was primarily attributed to improved cash flow during the period. The Company is seeking additional equity financing and debt settlements to overcome its negative working capital position and meet its future financial requirements.

### **Contractual obligations**

The Company's contractual obligations have not changed from that stated in its audited financial statements and MD&A for the fiscal year ended September 30, 2004.

### **Share capital**

The Company has 20,481,194 common shares outstanding as at the date of this report. In addition, there were 1,760,000 options outstanding under the Company's stock option plan and 940,000 warrants outstanding related to a private placement of common share units in March 2004. Details of these options and warrants are included in the notes to the financial statements.

### **Related party transactions**

The shareholder loan and accrued interest, in total \$262,808, is repayable on demand, bears interest at 10% per annum and matures on June 10, 2005.

Included in accounts payable are \$41,195 owed to a company controlled by a director of the Company for provision of services. During the period, \$7,000 was paid to such company. The services provided were in the normal course of business and valued at amounts agreed to the parties.

## **Risks and Uncertainties**

IWG recognizes that certain risks are inherent in its business plan:

### **Aircraft markets**

The Company's primary customers are business use aircraft manufacturers, owners and operators. Such markets are cyclical over time although often differing from the cycles for commercial aircraft. Sales are made on a standard or optional basis and are dependent upon the production rates and customization of new aircraft or the requirement for upgrading existing aircraft by owners.

### **Competition**

#### Aviation - Potable Water Treatment

At this time, there are no other companies of significance supplying flight certified potable water disinfection equipment to the aircraft industry, and IWG dominates the market. It is expected that competition will come, although IWG intends to remain the dominant player in this field because of its significant head start, and by developing new products, pricing new and existing products as though competition exists, and continuing to seek customer input. From time to time very small players attempt to penetrate the market, but none have been successful. There is an initiative by a company to enter the market with a system tailored specifically to the Airbus A380 using an alternate water treatment technology. A variety of water filters are used by some airlines and operators, but these do not actively treat and disinfect the water.

#### Aviation - Potable Water Systems

Currently, IWG is aware of several major full water systems providers in addition to itself. Their focus tends to be on the airliner/ regional jet markets, whereas the Company currently places most of its attention on the corporate/ VIP jet market. At least one of the companies competes directly in the corporate/ VIP market. A variety of companies provide components to aircraft manufacturers for inclusion in their potable water system designs, but only IWG and these firms are offering aircraft manufacturers a full system solution as a kit

### **Foreign Exchange**

Generally, fluctuations in the Canadian to United States dollar exchange rate are recorded as transactions occur and at the end of the period financial results are reported. The details of the Company's foreign exchange policy are included in the notes to the annual audited financial statements.

A majority of the Company's sales are invoiced in U.S. dollars, which are offset to some extent by the portion of its product costs, consulting and contractor costs that are also in U.S. dollars. Consequently, fluctuations in the Canadian to U.S. dollar foreign exchange rates will impact sales revenue, gross margins and net earnings reported by IWG. With the shift in US/ Canada exchange rates in recent periods, this is an area of risk.

The Company has not previously employed any financial instruments to hedge its foreign exchange position, because its past sales contracts generally have been short term. However, as the Company succeeds in securing longer-term production supply contracts, hedging of future foreign exchange requirements may be implemented.

### **Financial Resources**

The continued growth and viability of IWG will be affected by its ability to achieve profitable operations, by the continued support of its significant creditors, and by its ability to attract additional capital. The Company has not been able to meet the payment terms for two of its major debt instruments and has been in negotiations to restructure such debt. The Company has also negotiated extended terms with some suppliers. However, to improve its working capital position, properly establish its presence in the aviation market, and to achieve sales growth targets, additional financing is being pursued. This subject is also addressed under the separate section on Liquidity and Capital Resources.

This is not an exhaustive list of the various risk factors that may be faced by the Company, but is a specific reference to the major risk factors addressed by the Company.

### **Business outlook**

Development activity pursued by IWG in recent years has assured that its UV based water treatment products and systems are at the leading edge of aviation market requirements. This market has emerged from its post 9/11 turndown, and potable water quality is being perceived as an increasingly important issue, as evidenced by recent EPA reports.

International Water-Guard Industries, historically a developer of UV-based water treatment equipment for several niche markets has become a primary supplier of engineered water treatment units and systems for the aviation market. IWG's goal is to significantly grow its business as a provider of water systems and disinfection units to the aviation industry.

### **Other information**

Additional information relating to the Company is available under the Company's name on SEDAR at [www.sedar.com](http://www.sedar.com).